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STATE FOR EAP/CM AND EEB/OMA

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EFIN, ECON, EINV, PGOV, CH
SUBJECT: Beijing Welcomes Coordination in Financial
Crisis; Concerns about Growth Going Forward

REF: A. Hong Kong 1747 and previous, B. E-mail
Shanghai Financial Update, Friday, September 19, 2008
¶C. e-mail Shanghai Update 9-18-2008: Local Reaction to
the U.S. Financial Crisis D. Shanghai 402 and previous
¶E. Beijing 3501

¶1. Summary. Chinese Government officials praised U.S. Government willingness to brief them regularly on developments in the financial sector, particularly given their exposure to GSE debt. Although the direct exposure of Chinese firms to other troubled financial institutions is limited, most Beijing officials and academics expressed concern about the adverse impact on U.S. domestic demand and global market sentiment. Several officials noted China's desire to deploy its foreign assets in a way that promotes financial stability, but foreign exchange managers remain cautious about risky investments and uncertain as to whether they can overcome U.S. regulatory barriers and perceived U.S. political resistance to greater Chinese investment in U.S. financial institutions. The crisis has driven home the fact that China is now integrated into the world economy, leading to some comments in the popular media that it should seek to insulate itself. Others have blamed the United States for exporting the cost of recovery to the world, or even causing the crisis itself. These views, however, have been characterized as "extreme" and have not been espoused by mainstream media, officials or academics. End Summary.

Officials Welcome Explanations

¶2. (SBU) Chinese Central Government officials expressed appreciation for USG efforts to explain the details of plans to handle troubled American financial institutions. They have been particularly interested in Fannie Mae and Freddie Mac (see ref E). (Note: The State Administration for Foreign Exchange holds about half a trillion dollars of Fannie Mae and Freddie Mac debt. A combined Treasury/Morgan Stanley team briefed officials from the State Administration of Foreign Exchange (SAFE), China Investment Corporation (CIC),

the People's Bank of China (PBOC), Ministry of Finance (MOF), China Banking and Regulatory Commission (CBRC), Industrial and Commercial Bank of China (ICBC) and the Agricultural Bank of China (ABC) on the situation surrounding Fannie Mae and Freddie Mac. Treasury Under Secretary McCormick has called counterparts at the SAFE, PBOC, CBRC and MOF. Embassy officials have also discussed the bailout with academics at the Chinese Academy of Social Sciences (CASS) and the National Development Reform Commission (NDRC). End note.)

¶3. (SBU) While noting that China's direct exposure to other troubled private institutions is limited (see ref B and C), Chinese officials have praised the USG's willingness to keep the Chinese Government constantly apprised of current actions. Vice Premier Wang Qishan told Secretary Paulson in a phone conversation that China appreciates and supports all of the measures the U.S. Government has taken, and also Under Secretary McCormick's efforts to reach out to CIC, PBOC and SAFE. Prominent NDRC economist Xia Bin noted that, because of ties built during the Strategic Economic Dialogue (SED), U.S. and Chinese officials are now able to pick up the phone and talk to each other in order to coordinate responses to economic crises.

China Response

¶4. (SBU) The Chinese official media reported that President Hu Jintao expressed hope that U.S.

Government efforts would succeed in stabilizing the U.S. financial system, which he said would be in the interests of both the United States and China. In a private conversation with Treasury Secretary Paulson, Vice Premier Wang stated very clearly that China will do whatever it can to help, but this must be done on the basis of the "win-win" principle and be mutually beneficial. MOF officials similarly told Embassy officials that they stand ready to assist if necessary, asking if there was anything they should do.

¶5. (SBU) Chinese academics echoed this response. A CASS economist in the Economic Research office had a very positive view of the USG's response to the financial crisis. Although U.S. measures to "rescue" the financial markets were certainly motivated by U.S. self-interest, he said China and other countries should nevertheless cooperate with the United States, as this is a situation that will impact everyone given the extent of globalization. The USG acted "responsibly" by signaling to the international community that the United States will use all of its assets to reduce the current market difficulties, he emphasized.

Should China "Buy American"

¶6. (SBU) A few observers have noted that China, both through official and commercial financial institutions, has the foreign assets to rescue troubled U.S. financial firms. China Securities Regulatory Commission (CSRC) International Affairs Director General Tong Daochi asked whether the United States would be receptive towards Chinese firms taking large stakes in U.S. financial firms, both from a regulatory and more importantly political perspective. China Export-Import Bank Chairman Li Ruogu also commented to an Embassy official that U.S. efforts to stabilize financial markets should be done in cooperation with China and utilize China's large reserves of capital.

¶7. (SBU) CIC Deputy General Manager Jessie Wang, however, said that given losses on high profile investments in the U.S. financial sector to date (e.g. Blackstone), China's State Council is being more cautious about letting Chinese firms invest abroad in the financial sector. Chinese firms are cautious, despite low prices, because they see U.S. investors, who have a greater understanding of risks, hesitating.

Concern Over Broader Impact

¶8. (SBU) Although Chinese officials point out that Chinese firms have little direct exposure to U.S. financial institutions beyond the GSEs, many note that continued financial stress will adversely impact U.S. domestic demand and result in lower growth for China. CSRC's Tong said the Chinese side is concerned about the impact on the real economy and demand for Chinese exports. There is also an additional psychological impact, as a weak U.S. economy and financial markets could depress Chinese investor sentiment.

¶9. (SBU) A CASS industrial economist said the US financial bailout is definitely affecting Chinese industrial sectors which have higher ratios of export dependency. He noted, however, that the media has exaggerated the U.S. financial bailout's impact on China. He said that industrial production was already slowing for a variety of reasons independent of overseas demand.

Reform Threatened?

¶10. (SBU) Many officials have noted that the global economic situation may reduce support for continued market reform, particularly in the financial sector. Next month's Third Plenum of the Communist Party's 17th Central Committee is expected to address major macroeconomic issues such as rebalancing the economy away from an excessive reliance on exports and towards increasing rural incomes. A CASS foreign policy academic noted that the Government's ability to do so will be hindered, however, if the current crisis dramatically impacts Chinese exports now.

¶11. (SBU) The academic said that the West has been pressing for further reform and opening of the PRC's financial markets. But the current crisis has sparked a significant debate within China, with some arguing that the ongoing financial troubles demonstrate that China should not integrate with or open further to the international financial system. Others, however, are arguing that China, like its national basketball team, has no choice but to open itself further to international competition, particularly if it is to remain competitive globally.

¶12. (SBU) Regarding specific reforms, China will certainly proceed cautiously in the next few months with financial deregulation. CSRC Assistant Chairman Jiang Yang announced last week that China will proceed "safely" with futures market innovations, and they will be more cautious regarding arrangements for stock index futures. Many officials are still supporting innovation. PBOC Survey and Statistics Department Director General Zhang Tao told reporters that his lesson from the U.S. crisis was that market supervisors did not monitor markets. He proposed that China improve its financial supervision, but should not abandon developing a mortgage-backed securities market.

More Active Government Role in Markets Considered
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¶13. (SBU) The CASS foreign policy scholar noted that, in recent years the Chinese Government has been reluctant to intervene aggressively in China's stock and real estate markets. After witnessing the USG's massive intervention in these same sectors, however, some Chinese officials and scholars are reconsidering the role Beijing should play.

¶14. (SBU) Some observers have countered the call for a more activist Chinese Government approach to markets. Hu Shili, Editor of the respected economic weekly Caijing, published an editorial stating that "the U.S. bailout has nothing in common with a wished-for shoring up of the Chinese property market... There are no signs that property market risks are spreading to other institutions." CSRC's Tong said the recent moves by the Federal Reserve and Treasury gave CSRC cover to intervene in the market as part of global actions without increasing expectations for future intervention (see refs A and B).

China Tied In

¶15. (SBU) America's financial woes have driven home to many Chinese academics and officials exactly how involved China is in the global economy. The CASS foreign policy scholar, who admintted he is not normally involved in economic issues noted that, after 30 years of reform, China's integration into the world economy means that China undoubtedly will be affected by the current U.S. financial crisis.

¶16. (SBU) A CASS international economist, however, was not daunted by that integration, and was highly confident in China's ability to confront this crisis. "Nothing is impossible in China," he said, noting that the PRC Party-State is, after all, the system that threw tremendous resources at confronting the massive snowstorms and the Sichuan earthquake earlier this year, not to mention pulling off a spectacular Olympics. The Chinese system can handle the shocks produced by this crisis, he averred.

A New Model

¶17. (SBU) Some popular media and blogs have called for China to try to extricate itself from this dependence on foreign markets. The official People's Daily, in an overseas edition editorial by Shi Jianxun, states that the "sub-prime crisis has exposed immense gaps in the United States' financial oversight and supervision... the world urgently needs to create a diversified currency and financial system and fair and just financial order that is not dependent on the United States."

U.S. Image

¶18. (SBU) Although most Chinese reporting on the crisis has been fairly straightforward, some media reports blamed the United States for making mistakes and then forcing the rest of the world to bear the costs. For example, the official Communist Party international news publication Global Times (widely recognized for its nationalist views) on September 17 reported that "the whole world is bearing the price of the U.S. financial crisis... U.S. national egotism, which uses the U.S. dollar's hegemonic position to

exploit the world, is the primary cause of the crisis."

¶19. (SBU) Most media and academic experts dismissed this rhetoric. The September 22 edition of the International Herald Leader commented, "The U.S. economic position is unchallengeable.... U.S. vitality is experiencing some challenges. Whether or not the U.S. will fall depends on how effectively it adjusts its hegemonic mold, acclimating to the world." The CASS foreign policy academic did not think the crisis would harm the image of the United States in the region. He had no sense that people were questioning the U.S.'s leadership role or its trustworthiness. He had heard no one comparing the current crisis to the 1998 Asian financial crisis, arguing that the parallel people here are drawing is to 1929 -- and the obvious desire to avoid that outcome -- not 1998.

¶20. (SBU) The CASS international economist noted that there were some academics arguing that the United States was itself behind the current crisis and is now attempting to force the burden caused by it on the rest of the world. However, he characterized these views as "extreme" and said they were held only by a minority of "leftists."

¶21. (SBU) Chinese business has certainly lost some confidence in U.S. financial institutions, with one investor stating that U.S. financial operators had failed to accurately assess risk. An American working in Beijing at a major firm handling overseas IPOs, however, still thought that once stability returns to the markets, the U.S. exchanges will be the premier place for Chinese companies to list.

Comment

¶22. (SBU) Most Chinese officials, academics, and the official media have publicly and privately supported the U.S. approach to restoring confidence in U.S. financial markets. They have been especially thankful for timely and frequent personal briefings on U.S. government actions. Chinese officials' statements have been extremely disciplined, sticking to a few safe talking points generally endorsing moves that will enhance stability and letting PBOC Governor Zhou take the lead. Several financial officials acknowledge that China's official reserves are too large to meaningfully reallocate assets without adversely impacting the value of its investments. For the time being, Beijing appears unlikely to make any dramatic decisions regarding their approach to the United States.

¶23. (SBU) Over time, as markets stabilize, the events of the last month may strengthen the hand of opinion leaders advocating a more diversified and independent approach to international economic and financial engagement that involves a larger role for China. A Japanese central banker recently said that Chinese officials have approached him about etablishing a "yuan-yen" basis for trading in Asia. MOF officials have stressed how existing international financial institutions, such as the IMF, appear to be increasingly irrelevant in dealing with global economic problems.

¶24. (SBU) The downturn in the U.S. economy is likely to spur efforts by Chinese firms to continue to diversify their exports markets. Moreover, as Chinese firms become increasingly export oriented and

established in overseas markets, China's economic and financial integration with, and its vulnerability to changes in, the global economy will continue to increase, irrespective of government policies. And despite the public rhetoric about the need to reduce their dependence on the U.S. financial system and policies, Chinese authorities do not yet appear prepared to adopt the main reforms needed to achieve this, namely de-linking the RMB from the U.S. dollar, which would allow China to have a more independent monetary policy, and allowing unhindered capital flows, so the RMB can be used as the basis for international trade and financial transactions.

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